Consider Fixed Annuities for Your Client's Fixed-Income Portfolio

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When interest rates rise, owning a fixed annuity may be safer for clients than investing in a bond fund, the author says. (Photo: Thinkstock)

While most experienced agents and advisors know a great deal about annuities, newer financial pros just starting to work with annuities may not know about all their advantages. And it doesn't hurt for experienced agents to have a refresher.

Fixed annuities can substitute for bonds for part of a client's fixed-income allocation.

(Related on ThinkAdvisor: Fixed annuity sales hit record $117.4 billion in 2016)

Clients can lose money in bonds. The market value of a bond fluctuates with changes in interest rates. If rates go up and the client sells a bond prior to maturity, it will be worth less than its original cost. With an individual bond, the client can avoid this problem by holding it to maturity.

But investors in bond funds don't have that option. If rates spike up after the client buys a fund, the value will decline. Especially with a long-term bond fund, they may never recover their full principal.

Owners of individual bonds (except Treasuries) also face default risk. A company or municipality may run into financial problems and fail to make timely interest or principal payments. A default means the client could lose part or all of the investment.

In contrast, an annuity is guaranteed by the issuing insurance company. While state regulators constantly monitor the financial strength of insurers, in a severe financial crisis it's possible that an insurer could fail. That's why state guaranty associations provide an additional level of protection.

With fixed annuities, the insurance company bears the underlying investment risk, shielding annuity owners from both bond market volatility and default risk.

Bonds normally pay earnings every six months. With most individual bonds, the client can't reinvest interest so that it can grow and compound.

Bond funds let the client reinvest the dividends automatically, but the price per share varies as interest rates change. The client may have a gain or loss on reinvested dividends when the client cashes in the fund.

Fixed annuities let the client reinvest interest earnings without risk. Reinvested earnings earn the same rate as the base annuity, so the yield is guaranteed. Contract owners who need income can choose to receive interest earnings monthly, quarterly or annually.

Interest from corporate bonds and Treasuries is taxable in the year it's received. Annuities are tax-deferred.

All interest earnings left inside the contract grow and compound tax-deferred until withdrawn, a significant tax-planning benefit. The client can wait until retirement, when the client's tax bracket is likely to be lower, to start receiving payments.

Many corporate and municipal bonds are callable. When rates are high, it may look like the client has nailed down a great deal. However, a few years later when rates are lower, the issuer may call the bond back and the client will have to reinvest the proceeds at a lower rate.

Annuities can't be called. The interest rate is set for the duration of the guarantee period.

Annuities offer the ability to create a guaranteed lifetime income stream via annuitization. It's the only financial product that offers this option.

There are a few downsides to fixed annuities.

First, they have less unpenalized liquidity than bonds and bond funds. The client can always cash them in, but they'll pay a penalty for early surrender. Second, interest earnings withdrawn prior to age 59½ may be subject to a 10% IRS penalty.

Because annuities have less liquidity than bonds, the client would probably not want to put all fixed-income investments in annuities.

But there is some liquidity, through annuity features that let policyholders withdraw up to 10% of the principal a year penalty-free, for example. They're thus more liquid than bank

CDs, which have stiff penalties for early withdrawals.

When helping your clients invest the fixed-income part of their portfolio, don't consider only bonds. Adding fixed annuities to the portfolio is often a superior solution.

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